MCI

MCI Telecommunications Corporation
1801 Pennsylvania Avenue, NW
Washington, DC 20006

DOCKET FILE COPY ORIGINAL

RECEIVED

SEP - 1 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

ORIGINAL

September 1, 1993

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, D.C. 20554

Re: In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179

Dear Mr. Caton,

Enclosed herewith for filing are the original and nine (9) copies of MCI Telecommunications Corporation's Reply Comments in the above captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI pleading furnished for such purpose and remit same to bearer.

Sincerely,

Michael F. Hydock for
Randy R. Klaus, CPA
Senior Staff Member
MCI Telecommunications Corp.

No. of Copies rec'd 0+9
List A B C D E

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
	)	
Price Cap Regulation of Local Exchange carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing and Lower Formula Adjustment	)	

REPLY COMMENTS

MCI Telecommunications Corporation, Inc.
1801 Pennsylvania Ave, N.W.,
Washington, DC 20006

September 1, 1993

TABLE OF CONTENTS

SUMMARY

MCI Telecommunications Corporation respectfully submits its Reply Comments on the Commission's NPRM involving sharing and lower formula adjustments. MCI's Reply Comments demonstrate that the issue before the Commission in this NPRM is not about "tinkering" with or changing the price cap rules. The issue before this Commission is to clarify "how" to correctly calculate historic, earned rates of return for regulatory purposes.

If rates of return are not correctly calculated, customers will not get full credit for their share of local exchange carrier ("LEC") earnings which exceed certain levels under price cap regulation. If rates of return are not correctly calculated, the additional revenues customers are required to pay when LEC earnings fall below 10.25 percent will not be included in LEC rate of return calculations. Simply put, there are no legitimate reasons for not correctly calculating LEC rates of return.

There is no unanimity within the LEC industry as to how sharing and low-end adjustments should be treated when calculating rate of return. The positions taken by the LECs are all partially wrong and entirely self-serving. Moreover, most LECs have mischaracterized the nature of this proceeding and greatly exaggerated their claims in order to avoid their sharing obligations and thereby increase their earnings through the backdoor.

The calculation of rates of return is a "stand-alone" event which does not change just because of a change in the way prospective rates are set. The methodology for calculating rates of return under rate-of-return regulation are still valid today, when calculating rates of return under price cap regulation.

MCI's Reply Comments will specifically address the following:

1) the notion that the <u>AT&T court case</u>, which invalidated the automatic refund rule, requires add-backs for both the sharing and LFA amounts;

2) the proposal to <u>defer</u> the add-back issue to the comprehensive price cap review; and

3) the proposal to allow <u>credits</u> for below-cap rates.

For the reasons contained herein and in MCI's initial Comments, MCI respectfully requests the Commission to require sharing add-backs, but not LFA add-backs when computing LEC rate of returns.

RECEIVED

SEP - 1 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
	)	
Price Cap Regulation of Local Exchange carriers Rate of Return Sharing and Lower Formula Adjustment	)	CC Docket No. 93-179

REPLY COMMENTS

MCI Telecommunications Corporation ("MCI") hereby respectfully submits its Reply Comments on the Commission's Notice of Proposed Rulemaking ("NPRM") in the above-captioned matter.

In its NPRM, the Commission proposes to exclude both sharing and lower-formula-adjustment (LFA) amounts from the calculation of local exchange carrier rates of return.[1]

The issue before the Commission in this NPRM is not about "tinkering" with or changing the price cap rules; it is simple and straight forward. The issue before this Commission is to clarify how to correctly calculate historic, earned rates of return for regulatory purposes.

If rates of return are not correctly calculated, customers will not get full credit for their share of local exchange carrier ("LEC") earnings which exceed certain levels under price cap regulation. If rates of return are not

1 See, In the Matter of Price Cap Regulation of Local Exchange Carriers, Rate of return Sharing and Lower Formula Adjustment, ("NPRM"), para 4 and Appendix B.

correctly calculated, the additional revenues customers are required to pay when LEC earnings fall below 10.25 percent will not be included in LEC rate of return calculations. Simply put, there are no legitimate reasons for not correctly calculating LEC rates of return right now, instead of deferring such matters to the price cap review.

There is no unanimity within the LEC industry as to how sharing and low-end adjustments should be treated when calculating earned rates of return. Some LECs have taken the position in their comments that no sharing/low-end adjustments should be made when calculating rates of return, while others have endorsed the Commission's NPRM to add-back both sharing and lower formula adjustments. Both positions are partially wrong and entirely self-serving. Moreover, most LECs have mischaracterized the nature of this proceeding and greatly exaggerated their claims. Most of the LECs are simply attempting to avoid their sharing obligations and thereby increase their earnings through the backdoor.

The calculation of earned rates of return for regulatory purposes does not change just because the form of regulation changes. The calculation of rates of return does not change just because of a change in the way prospective rates are set. The calculation of earned rates-of-return is a stand-alone event which is independent of the prospective rate-setting process. Consequently, the methodology for calculating rates of return under rate-of-return regulation are still valid today, when calculating rates of return under price cap regulation.

I. Introduction

MCI's Comments in response to the Commission's NPRM demonstrated that:

1) sharing amounts must be excluded from the computation of current-period earnings by way of the add-back in order to ascertain whether or not any new sharing obligations exist with regard to the current period;

2) the proposed LFA add-back unequivocally and permanently excludes the additional revenues derived from LFA-related rate increases from ever being included in the calculation of base period earnings;[2]

3) the proposed LFA add-back effectively insulates price cap LECs from earning below a 10.25 percent rate of return under price cap regulation--a guarantee which is tantamount to retroactive ratemaking and not provided for under rate of return regulation;

4) under price caps, the LFA was intended to save LECs from low earnings over a prolonged period of time, not guarantee LECs a minimum rate-of-return of 10.25 percent;

5) the proposed LFA add-back is inconsistent with the objectives of price cap regulation because it significantly diminishes the incentives for LECs to improve their performance;

6) earnings calculations are intended to ascertain if LEC earnings have exceeded some prescribed level and, under price caps, to quantify the amount of any prospective rate increase in the event that low

---

2 See, MCI's NPRM Comments, TABLE 1, at p 9 for quantitative proof that the proposed LFA add-back permanently excludes the additional revenues associated with LFA rate increases from ever being included in the calculation of base period earnings.

prior-period earnings exist, and not to expressly or primarily evaluate productivity growth; and

7) the LFA add-back was not necessary or appropriate to determine new sharing obligations or LFA rights.

MCI stands by its Comments.

MCI will not rehash the aforementioned matters in opposition to various comments made by the LECs in this proceeding. Instead, MCI will limit its Reply Comments to matters not previously discussed in its Comments.

Specifically, MCI's Reply Comments will address the following:

1) the notion that the AT&T court case,[3] which invalidated the automatic refund rule, requires add-backs for both the sharing and LFA amounts;

2) the proposal to defer the add-back issue to the comprehensive price cap review; and

3) the proposal to allow credits for below-cap rates when calculating sharing amounts.

II. The Court Case -- AT&T v. FCC -- is Irrelevant

In its comments, NYNEX claims that price cap regulation will be legally invalidated if the Commission does not require the add-backs for both sharing and lower-end adjustments.[4] NYNEX bases its claim on the AT&T v. FCC Court findings which invalidated the automatic refund rule. NYNEX is wrong.

---

[3] American Tel. and Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988)

[4] See NYNEX NPRM Comments at pp 3-6.

NYNEX specifically claims that if the Commission applied the LFA in a way that would "tend to drive" LEC earnings "below" the LFA level (10.25 percent), the Commission would contradict its own rate of return findings in the same way that it did in AT&T v. FCC.[5] NYNEX also claims that such action by the Commission would be confiscatory.[6] NYNEX suggests that the Court held that regulated carriers are guaranteed a minimum rate of return, and that the aforementioned court decision somehow addressed the particulars of how to calculate earned rates of return for regulatory purposes. Moreover, NYNEX would have this Commission believe that LFA-related rate increases, in any given year, are expressly intended to recover the costs of providing service which were incurred in a prior year. NYNEX is wrong for several reasons.

First, NYNEX's position is tantamount to retroactive ratemaking. Rates may not be set to recover prior costs.[7] Moreover, LEC rates of return are not, and have never been, guaranteed, even under rate of return regulation. Finally, the AT&T case is irrelevant because the sharing mechanism under price caps is nothing like the automatic refund rule and because the Commission, in its most recent rate of return

---

5 Id., at p 5.

6 Id., at p 6.

7 See Communications Satellite Corp. v FCC, 611 F. 2d 883, 892-94 (D.C. Cir. 1977); Nader v FCC, 520 F. 2d 182, 202 (D.C. Cir. 1975).

represcription, categorically stated that it does not consider the currently authorized rate of return to be both a "minimum and maximum."

MCI does agree with NYNEX about one thing: The AT&T case invalidated the automatic refund rule. The automatic refund rule was invalidated because "the Commission's own understanding of its rate of return prescription and of its [automatic] refund rule constitutes a self-contradiction."[8] That is the Court's holding. The Court did not invalidate the Commission's methodology for calculating carrier rates of return. The calculation of rates of return was taken as a given and was not at issue. Indeed, the court made no findings whatsoever regarding the Commission's methodology for calculating rates of return, nor did it invalidate Form 492 or any of the instructions thereto.

Even though the court affirmed the long standing view that regulated carriers are not guaranteed a rate of return, NYNEX argues that the LFA add-back is necessary so that LEC earnings are not driven below the LFA level (10.25 percent). The AT&T Court, however, reaffirmed "the business risk that a carrier is bound to accept under the accepted view that regulation does not guarantee the regulated company a profit".[9] The Court clearly did not state or in any way

---

[8] AT&T v. FCC, supra 836 F.2d at 1391.

[9] Id. at 1390-91 (emphasis added).

imply that regulated carriers are guaranteed a minimum rate of return.

In substituting price cap regulation for rate of return regulation, the Commission made it clear that LECs should be facing greater risks and that they should be even less assured of earning the target rate of return than they were under rate of return regulation. The Commission unequivocally rejected the concept of a guaranteed, minimum rate of return when it stated:

> A guarantee of earnings at the full level of the prescribed rate of return eliminates genuine risk and is thus overly favorable to LECs and inimical to this [incentive regulation] approach. LECs request that the plan accord them an assurance that their earnings will not slip below the prescribed rate of return, forgetting that this earnings level is a target, not a certainty, even under rate of return regulation. The plan gives LECs flexibility and the right to retain more of their earnings; it balances these opportunities against the possibility that LECs might earn less if they fail to respond to the incentives provided. LECs are reasonably expected to become more efficient in order to earn higher profits, or even to maintain their current profits....If the formula applies harmfully to any particular LEC, the lower adjustment mechanism offers a remedy, while still providing an incentive to become more profitable by increasing efficiency, not rates.[10] (Emphasis added)

In addition, the Commission noted the following with regard to the AT&T case:

> We wish to clarify that the sharing devices we are proposing here are substantially different than the automatic refund mechanism struck down in AT&T v. FCC, supra. In that case, an automatic refund was applied to

---

10 See Order on Reconsideration, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313 (released April 17, 1991), para. 117

> all earnings in excess of the unitary rate of return, with no corresponding automatic correction for earnings below it. In our instant proposals, however, earnings are shared with ratepayers in a manner that ensures that carriers can retain earnings within a price cap zone of reasonableness if they can generate such earnings. The sharing we propose could not force the carrier's average return below the zone of reasonable earnings we propose to create. Our proposal to increase prospectively a carrier's price cap indexes to the lower "formula adjustment" level ensures that carriers will have a reasonable **opportunity** to earn within the price cap zone of reasonableness.[11] (Emphasis added)

Thus, the AT&T case is irrelevant because the large LECs are no longer governed by rate of return regulation and because the sharing mechanism, together with the LFA, are totally unlike the automatic refund rule struck down in the AT&T case.

Moreover, in its 1990 represcription Order, the Commission clearly explained that the authorized rate of return was not both a minimum and a maximum rate of return. The Commission stated:

> In light of the ruling in the... [AT&T case], in which the Court of Appeals determined that our automatic refund provision was at odds with our own understanding of our rate of return prescription, we wish to clarify that we do not view this prescription as "both a maximum and a minimum." That is, it does not represent a unique balance point such that "[i]f the rate were higher, the balance would tip in favor of the investor; if lower, it would tip in favor of the consumer." Our accumulated experience with rate of return prescriptions, and our review of the cost of capital evidence in this proceeding, convince us that there is no such point. Indeed, even the lower boundary of our range of cost of capital estimates does not represent a bright line such

11 See Supplemental Notice of Proposed Rulemaking, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313 (released March 12, 1990), para. 172.

> substantial gap between an earnings level that is fully adequate to assure attraction of capital on favorable terms, and an earnings level which, if sustained over time, would be confiscatory.[12] (Emphasis added)

Thus, even if rate of return regulation were still applicable to all LECs, there would be no inconsistency between the automatic refund rule and the Commission's understanding of its rate of return prescription. The AT&T case would therefore be decided differently now, under the Commission's stated understanding of the current rate of return prescription. That case is accordingly doubly irrelevant now to price cap LECs, and, in any event, never had any bearing on how to calculate earned rates of return.

III. The Proposal to Defer Action on How to Calculate Rates of Return is Inappropriate

Bell Atlantic, BellSouth and GTE propose to defer any action with regard to rate-of-return calculations to the comprehensive price cap review.[13] Bell Atlantic characterizes the sharing add-back in rate-of-return calculations as a substantial modification to the price cap plan.[14] BellSouth

---

12 See Order, In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624 (released December 7, 1990), para. 217

13 See, Bell Atlantic NPRM Comments at pp 4-5; BellSouth NPRM Comments at pp 2-3; and GTE NPRM Comments at pp 14-15.

14 See, Bell Atlantic NPRM Comments at p 4.

and GTE state that the add-back issues would become "moot" if the Commission would eliminate the sharing provisions.[15] As noted earlier, the LECs have not raised any legitimate reasons for not correctly calculating rates of return right now.

MCI opposes the proposal to defer action on this matter, and takes exception to the notion that correctly calculating rates of return would constitute a "substantial modification" to price cap regulation.

In addition, the fact that the sharing add-back would become a moot issue when and if the Commission eliminates sharing is irrelevant. Just because the sharing add-back may become a moot issue in the future does not make it a moot issue today. Moreover, inaction on this matter at this time is simply inappropriate because it only benefits the financial interests of the LECs and their shareholders, at the expense of LEC customers.

IV. The Proposal to Allow Credits for Below-Cap Rates Will Allow Price Cap LECs to Avoid Sharing and Also Exceed Their Allowed Rates of Return

In its NPRM, the Commission raised the issue of whether LECs that charge rates below their price cap indexes should be given credit for the difference between their PCIs and APIs when calculating sharing amounts. The credit would supposedly recognize that the LECs have already passed along some portion

---

[15] See, BellSouth NPRM Comments at p 2; and GTE NPRM Comments at p 15.

of the sharing-related rate reductions by pricing below the cap. MCI disagrees with the proposal.

Ameritech, Bell Atlantic and BellSouth support the notion of providing credits for below-cap rates,[16] whereas NYNEX opposes such a credit.[17] MCI agrees with NYNEX that the below-cap credit proposal would be administratively complex and does not improve regulation under price caps. Moreover, the below-cap credit will allow price cap LECs to avoid sharing, in whole or in part, and thereby exceed the allowed rates of return under price cap regulation.

In its price cap order the Commission established a sharing mechanism based solely upon LEC earnings. The sharing mechanism requires LECs to share (credit) with customers 50 percent of their earnings between 100 and 500 basis points above 11.25 percent, and share 100 percent of their earnings above 16.25 percent when using a 3.3 percent productivity offset.[18] The price cap order did not contemplate or prescribe any ifs, ands or buts with regard to sharing.

For example, the Commission did not say that LECs are required to share 50 percent or 100 percent of their earnings above a certain level, but only to the extent that such

---

16 See, Ameritech NPRM Comments at p 7; Bell Atlantic NPRM Comments at p 7; and BellSouth NPRM Comments at pp 9-10.

17 See, NYNEX NPRM Comments at pp 12-13.

18 See Second Report and Order, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313 (released October 4, 1990), para. 7

sharing amounts exceed the difference between the LECs' PCI and API. The sharing provision under price caps is clearly a one-pronged test, not a two-pronged test.

Consequently, if below-cap credits are allowed, LECs will be provided with the opportunity to avoid sharing and, at the same time, realize earnings that exceed the level where sharing would have otherwise begun. The example which follows demonstrates how this would work.

This example is based upon a LEC earning at a level in which it would ordinarily be required to share 50 percent of its earnings above 12.25 percent. The LEC's actual earnings before sharing are 14.25 percent. In this example it is assumed that the LEC's rates were set such that its API was less than its PCI by an amount equal to its sharing obligation (i.e., 50 percent of the earnings above 12.25 percent). As shown in the table below under the column headed "WITH PCI/API CREDIT," the LEC's rate of return remains at 14.25 percent (which is above the sharing threshold) because it is <u>not</u> required to share any of its excess earnings by reason of the PCI/API credit. On the other hand, if the LEC is required to share 50 percent of its earnings above 12.25 percent, the LEC's earnings <u>after</u> sharing effectively fall to 13.25 percent.

TABLE 1

WITH PCI/API CREDIT	**WITHOUT PCI/API CREDIT**

TABLE 1

	WITH PCI/API CREDIT	**WITHOUT PCI/API CREDIT**
Revenues	$2,425	$2,425
Expenses	1,000	1,000
Rate Base	10,000	10,000
ROR	14.25%	14.25%
Sharing Obligation	100	100
PCI/API Credit	(100)	0
Effective ROR	14.25%	13.25%

As demonstrated by the table above, the below-cap credit is just another vehicle that would allow LECs to avoid sharing, and thereby increase their earnings above the levels expressly set forth in the Commission's price cap order.

Moveover, there is no valid public policy rationale for such a credit. The LECs already have, for all practical purposes, a "credit" for below-cap pricing, since the API is not reduced automatically when the PCI is reduced. Thus, if a LEC is already setting service basket 1 rates 10% below the PCI for that basket, and its sharing obligation requires it to reduce its overall rates by 10%, a 10% reduction in the PCI will not force the LEC to reduce its basket 1 actual rates at all. Thus, in that situation, there is already no sharing in the following year, at least for basket 1, even where the LEC has high earnings that otherwise require sharing. The additional credit that the Commission proposes here would allow the LEC in the hypothetical exampleto keep its PCI, as well as its actual rates, unchanged. A credit that would allow the LEC to avoid a PCI reduction would not only allow it to avoid its sharing obligations for basket 1, as is the case now, but would also allow it to raise its basket 1 actual rates up to the level of its unchanged PCI, thus earning even more. No public purpose would be served by such a double benefit.[19]

V. Conclusion

MCI has demonstrated that the court case had no bearing on "how" to calculate rates of return, and that such case affirmed the Commission's position that carrier earnings are not guaranteed. MCI also demonstrated that the below-cap credit will allow LECs to avoid sharing obligations and

---

19 It should be noted that, in its Price Cap Reconsideration Order, the Commission rejected MCI's proposal that the API be reduced by an amount equal to the amount by which the PCI is reduced for sharing when the API is below the PCI. The Commission stated that "an API adjustment would stifle the incentives we are trying to create, by providing a disincentive for LECs to exercise downward pricing flexibility created by the price cap system." Order on Reconsideration, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313 (released April 17, 1991), para. 111. MCI had argued that the API adjustment was necessary in order for ratepayers to receive the full amount of sharing. Id. at para.109. If the Commission now goes even further and allows the proposed credit, ratepayers will be deprived of the benefits of sharing, not so that the LECs will have the incentive to exercise downward pricing flexibility, but, rather, so that they can have the freedom to raise prices -- a goal directly contrary to the Commission's stated goal in the Reconsideration Order.

MCI therefore respectfully requests the Commission to require LECs to correctly calculate their earned rates-of-return, right now. This can be accomplished by simply requiring LECs to add-back amounts for sharing, but <u>not</u> lower-formula adjustments when calculating rates of return.

Respectfully Submitted,

MCI TELECOMMUNICATIONS CORPORATION

Michael F. Hydock for

Randy R. Klaus, CPA
Sr. Staff Member
701 Brazos St., Suite 600
Austin, Texas 78701
(512) 495-6723

Dated: September 1, 1993

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on September 1, 1993.

Michael F. Hydeck for

Randy R. Klaus, CPA
Senior Staff Member
701 Brazos St., Suite 600
Austin, Texas 78701
(512) 495-6723

<u>CERTIFICATE OF SERVICE</u>

I, Carolyn McTaw do hereby certify that copies of the foregoing MCI petition were sent via first class mail, postage paid, to the following on this 1st day of September 1993:

Kathleen Levitz**
Chief, Common Carrier Bureau
FCC
Room 500
1919 M Street, N.W.
Washington, DC 20554

Gregory J. Vogt**
Chief, Tariff Division
FCC
Room 518
1919 M Street, N.W.
Washington, DC 20554

Dan Grosh**
FCC
Room 518
1919 M Street, N.W.
Washington, DC 20554

Ann Stevens**
FCC
Room 518
1919 M Street, N.W.
Washington, DC 20554

Judy Nitsche**
FCC
Room 518
1919 M Street, N.W.
Washington, DC 20554

International Transcription Service**
FCC
Room 246
1919 M Street, N.W.
Washington, DC 20554

David L. Sieradzki**
Policy and Program Planning Division
FCC
Room 544
1919 M Street, N.W.
Washington, DC 20554

Francine J. Berry
American Telephone and Telegraph Company
Its Attorneys
295 North Maple Avenue
Room 3244J1
Basking Ridge, NJ 07920

James P. Tuthill
James W. Bogy
Pacific Bell/Nevada Bell
Their Attorneys
140 New Montgomery St., Rm. 1530A
San Francisco, CA 94105

Martin T. McCue
Vice President and General Counsel
United States Telephone Assoc.
900 19th Street, N.W. Ste 800
Washington, DC 20005-2106

Robert M. Lynch
Thomas A. Pajda
Southwestern Bell Telephone Co.
Attorneys for
One Bell Center, Ste. 3520
St. Louis, MO 63101

Rochelle D. Jones
Directory - Regulatory
The Southern New England Telephone Company
227 Church Street
New Haven, CT 06506-1806

Michael J. Shortley, III
Attorney for Rochester Telephone Corporation
180 South Clinton Avenue
Rochester, NY 14646

Edward R. Wholl
Joseph Di Bella
New York Telephone Company and
New England Telephone and Telegraph Company
120 Bloomingdale Rd
White Plains, NY 10605

Gail L. Polivy
GTE
1850 M Street, N.W.
Suite 1200
Washington, DC 20036

Michael S. Pabian
Attorney for Ameritech
Room 4H76
2000 West Ameritech Center Drive
Hoffman Estates, IL 60196-1025

Edward Shakin
Edward D. Young
Its Attorneys
Bell Atlantic Telephone Company
1710 H Street, N.W.
Washington, DC 20006

M. Robert Sutherland
BellSouth Telecommunications, Inc.
Its Attorneys
4300 Southern Bell Center
675 W. Peachtree Stree, NE
Atlanta, GA 30375

Hand Delivered**

Carolyn McTaw

Carolyn McTaw